U.S. DEPARTMENT OF ENERGY

Report on Carryover Balances
For Fiscal Year Ended September 30, 2005

February 2006

Prepared by: Office of Chief Financial Officer

CONTENTS

Purpose

On October 24, 1992, the President signed the Energy Policy Act of 1992 into law (Public Law 102-486). Section 2307 of the Act requires the Department of Energy (DOE) to submit an annual report to Congress on the status of its uncosted obligations (obligations recorded for specific deliverables that are not yet completed and accepted). This is the fourteenth annual submission of that report.

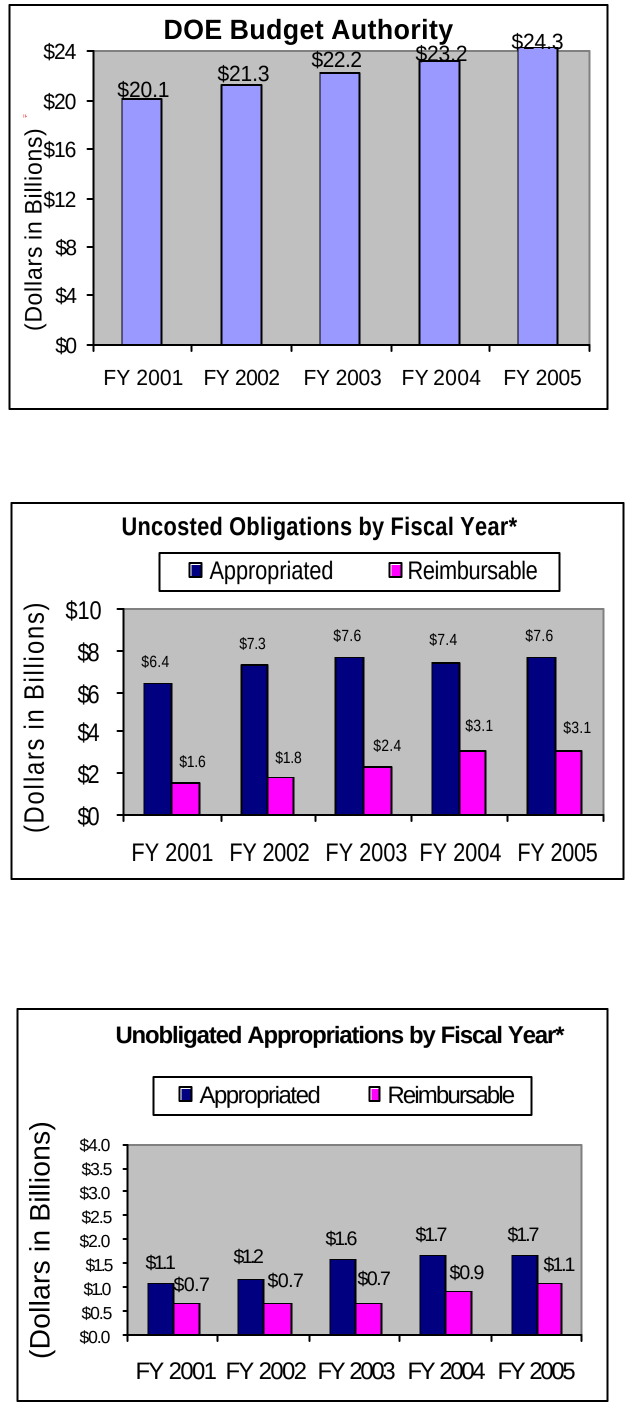
Analysis Results

As Exhibit 1 displays, the Department has averaged a $1 billion increase in budget authority over the last five fiscal years (FY). These increases have also been accompanied by continuing resolutions that have been in effect as late as the second quarter of the FY. Over the last four years, the Department's appropriated uncosted balances have remained relatively constant, ranging from $7.3 billion to $7.6 billion. Reimbursable uncosted obligations remained constant from 2004, following a $700 million increase primarily attributable to the establishment of long term (five to ten year) construction agreements with the Department of the Navy in FY 2004. Due to the up-front funding requirements for these agreements, higher than normal uncosted balances are expected. Balances will be reduced in the coming years as significant construction deliverables are completed.

Despite the annual increases in budget authority, the Department's appropriated unobligated balance remained unchanged from FY 2004. Taken together, these results indicate that the Department is managing its uncosted and unobligated balances effectively in relation to budget authority increases.

In addition to monitoring overall trends in uncosted obligations, the Department evaluates its individual appropriation balances against pre-defined thresholds (or targets) that

Exhibit 1



* Excludes Bonneville Power Administration

represent standard costing levels for various types of funding, such as construction, operating and capital equipment. While balances above these thresholds are not inherently inappropriate, they must be analyzed and justified to ensure they remain consistent with sound financial management and overall funding needs.

The Department's FY 2005 combined total balances exceeded the established threshold for all appropriations by $646.6 million[1]. The major driver for this variance is the Defense Nuclear Nonproliferation appropriation, which was $556.5 million over threshold. As has been reported in prior reports, this appropriation supports, but is not limited to, the following programs: Russian Transition Initiative (RTI), Materials Protection Control and Accounting (MPC&A), Fissile Materials Disposition (FMD), Elimination of Weapons Grade Plutonium Production (EWGPP), and Nonproliferation and International Security (NIS). These programs display inherently higher balances due primarily to the unique funding processes involved in work with Russia and the Former Soviet Union (FSU). Contracts under these programs require full up-front funding, and payments are not made until key deliverables are completed. The multi-year nature of the work typically delays the costing process, resulting in higher than normal year-end balances.

Other appropriations that were more than $30 million over threshold were the Nuclear Waste Fund, Fossil Energy Research and Development, Energy Conservation, Energy Supply, Strategic Petroleum Reserve Petroleum Account and Other Defense Activities. The $30 million level represents all individual appropriations with an over-threshold amount greater than 5% of the Department's total net amount over threshold, rounded down to the nearest $10 million. Drivers for these amounts include contracts delayed due to the effects of continuing resolutions, Presidential directives, multi-year cost-shared contracts that require up-front funding and costing over an extended period and the use of competitive contractual instruments that require additional time to generate award. Detailed justifications for the over-threshold amounts are provided in the "Explanation of Significant Threshold Variances" section of this report.

After considering the effects of annual increases in total budget authority since FY 2001 and the justification for the amounts significantly over threshold, we find the Department's balances to be at a level generally consistent with standard costing levels. However, the Department recognizes that there are always opportunities to enhance management control of our balances and will continue to seek innovative measures to more effectively manage and help reduce uncosted balances where feasible. For example, the Department will evaluate whether new management initiatives (such as a business management system being implemented in the Office of Energy Efficiency and Renewable Energy) may have broader applications, potentially helping to improve management of uncosted balances in multiple programs and appropriations.

Utilizing carryover balances[2] to offset future budget requests is also important to bring continuity of operations and ensure balances remain at an appropriate level. In FY 2005, the Department in concert with Congressional direction utilized $96.6 million in carryover balances to offset

[1] The total amount over-threshold of $646.6 million in FY 2005 is a "Net" figure consisting of over and under-threshold amounts for each appropriation.
[2] Carryover balances include uncosted obligations and unobligated funds.

funding needs. Appendix Chart 4 provides a breakout of the use of prior year carryover balances by appropriation.

<u>Composition of FY 2005 Year-End Uncosted Obligations</u>

Exhibit 2

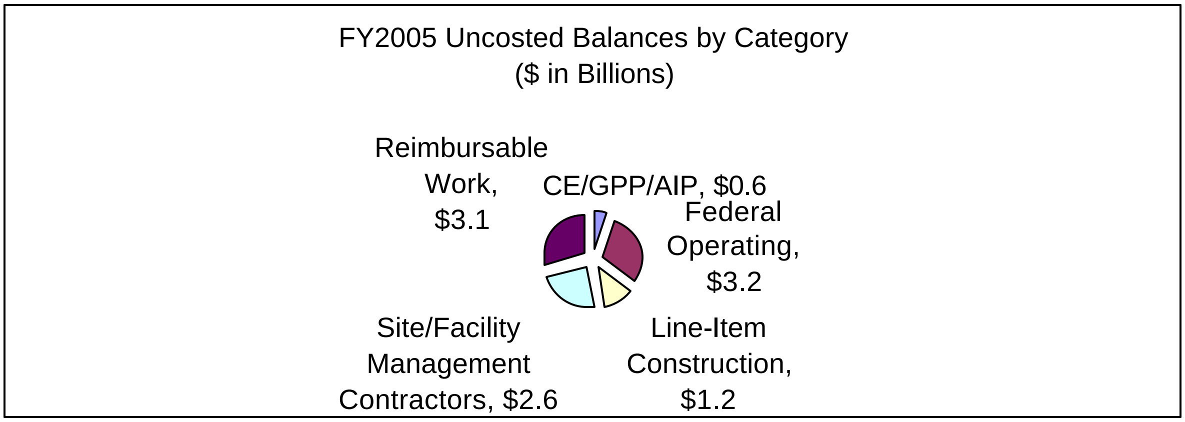


Exhibit 2 presents the composition of the Department's $10.7 billion uncosted balance as of September 30, 2005. Of the total uncosted amount, $3.1 billion was associated with reimbursable work funded by other Federal agencies and non-Federal entities. These funds are under external control and cannot be used to offset DOE appropriations. Another $1.2 billion is associated with line-item construction projects. Construction projects are reviewed on a case-by-case basis through other Departmental processes.

$600 million dollars of the total uncosted balance is related to Capital Equipment (CE), General Plant Projects (GPP) and Accelerator Improvement Projects (AIP). Another $2.6 billion is attributed to uncosted balances arising from the operating activities of the Department's Site/Facility Management Contractors (SFMC). The final $3.2 billion results from Federal operating activities not related to the other categories.

<u>Threshold Analysis - Approach and Background</u>

It is not possible to eliminate uncosted obligations completely. Uncosted obligations are required to meet that portion of existing contractual obligations related to goods and services that have not yet been received, used or consumed. DOE maintains a cost-based accounting system, consistent with Office of Management and Budget cost and accrual accounting requirements, to track these balances.

In April 1996, the Government Accountability Office (GAO) issued its report "DOE Needs to Improve its Analysis of Carryover Balances" (GAO/RCED-96-57). GAO stated that the Department did not have a standard, effective approach for identifying excess carryover balances that might be available to reduce future budget requests. Instead it relied on broad estimates of potentially excess balances in its individual programs. As a result, GAO indicated that DOE could not be sure whether the amount of carryover balances proposed for use by its programs was adequate, too small or too large.

Recognizing that there is a legitimate rationale for retaining some level of uncosted balances, and to address GAO concerns, DOE developed a comprehensive approach for the systematic analysis of uncosted balances. This approach is based on establishment of percentage thresholds specifying levels of uncosted balances consistent with sound financial management for specific types of financial/contractual arrangements. This allows the Department to evaluate its overall performance based on the variance between target thresholds and actual balances. The Department established the target thresholds through internal analysis and discussions with GAO.

A target threshold is defined as an analytical reference point (i.e., a specific dollar value or percentage of funds available) beyond which uncosted obligation balances should be given greater scrutiny. That does not mean balances in excess of threshold are inappropriate. It does mean those balances will become subject to more intensive review and require more detailed justification to determine their appropriateness.

In order to analyze those areas where the Department can exercise the most control, costs and uncosted balances are segregated into distinct categories that display similar and predictable costing patterns. Exhibit 3 outlines the various uncosted categories and their respective thresholds.

Exhibit 3

CATEGORY	THRESHOLD
Contractor Operating Costs: This category includes costs incurred by Site/Facility Management Contractors (SFMC) that manage Departmental sites.	**13% of the Total Funds Available to Cost (TAC)[3] for contractor operating activities for the FY year just ended.**
Federal Operating Costs: This category includes operating costs not related to SFMCs or other identified categories.	**17% of the TAC for Federal operating activities for the FY just ended.**
Capital Equipment (CE), General Plant Projects (GPP) & Accelerator Improvement Projects (AIP): This category includes costs incurred for CE, GPP and AIP. CE includes those items that meet the accounting criteria for capitalization.	**50% of the TAC for CE, GPP and AIP respectively for the FY just ended.**
Line Item Construction • **Grants** • **Cooperative Research and Development Agreements and other Cooperative Agreements** • **Reimbursable Work** • **Environmental Management Privatization**	**Not Subject to a Specific Threshold. These costs should be reported and evaluated on a case-by-case basis throughout the life of the contractual instruments. (Consistent with GAO's approach)**

The analysis process requires that all Departmental elements array their uncosted balances in a standard format that discloses programs with balances in excess of the defined thresholds. For each program that exceeds the defined threshold, a narrative justification is required which explains the major drivers for the balances, accompanied by a request to retain the balances

[3] Total Available to Cost (TAC) represents the total of all obligated amounts that are available for costing during the year. TAC is calculated as Beginning Uncosted + Current Year Obligations.

based on a defined planned usage, or an acknowledgment that the balances can be withdrawn for higher priority use.

Threshold Analysis - Summary

As noted earlier in this report, the purpose of the threshold approach is to provide a reference point beyond which further analysis is required to determine if a particular balance is appropriate or necessary. However, it cannot be assumed that any amount over threshold is inherently available or unnecessary. In addition to providing a basis for assessing the appropriateness of balances, this analysis helps to identify types of funding and contractual instruments that display inherently higher balances than typical operating funding. Categories such as line-item construction, grants, cooperative agreements, Environmental Management Privatization and reimbursable work have traditionally been exempted from threshold application. These exemptions are consistent with previous GAO treatment of DOE uncosted balances.

DOE's threshold analysis for FY 2005 shows that the Department as a whole is $646.6 million above its target threshold (Appendix Chart 3), an increase of $512.8 million versus FY 2004. Key appropriations driving this increase include Energy Supply, Other Defense Activities, Nuclear Waste Fund, Energy Conservation and Strategic Petroleum Reserve (Petroleum Account). These appropriations are included in the justifications in the Explanation of Significant Threshold Variances Section.

It is important to note that the amount over threshold represents a "net" amount at the Departmental level, and that this variance consists of a combination of over and under-threshold amounts for various appropriations. The over and under-threshold amounts allow the total value of the balances justified to exceed the $646.6 million variance at the Departmental level. Thirty-three out of 56 appropriations exceeded their target threshold for uncosted balances. The following section identifies the key drivers for appropriations with an over-threshold amount greater than 5% of the Department's total net amount over threshold, rounded down to the nearest $10 million (equals $30 million for 2005). The total amount justified equals over $1 billion.

Explanation of Significant Threshold Variances

Appropriation 89X0309, Defense Nuclear Nonproliferation (DNN) – Exceeds the appropriation threshold by a net amount of $556.5 million, primarily due to the rate and timing of costing for contracts and agreements with various foreign countries/entities related to the RTI, MPC&A, FMD, EWGPP and NIS programs, and long-lead procurements related to the Nonproliferation and Verification Research and Development (R&D) program.

Looking at costs alone, the uncosted balances for many of the DNN programs exceed DOE thresholds because of the costing patterns for the significant amount of DNN work conducted in foreign countries, including the Russian Federation and the Newly Independent States. Although most of this work is handled through operating contractors, business transactions with these countries, including contract negotiations and the subsequent accounting for these transactions, do not follow the normal obligation and costing patterns for typical operating contractors. Contract negotiations with a foreign entity may take from two to eighteen months to complete, and then work may take another three to six months to implement. Also, although funds are obligated up front on these operating contracts (many of which are multi-year in nature), costs are not reported until the work has been completed. Due to the uncertainties related to foreign government reviews, site access agreements, export controls, learning curves required to conduct the work and rework of unacceptable deliverables, the costs associated with these obligations may not be reported for three to twenty-four months after the work orders are placed. This unique situation does result in higher uncosted balances than many of the other programs whose business is conducted primarily within the United States.

Due to the nature of this work, relying on costs alone does not reflect an accurate assessment of the programs' financial status. Along with costs recorded in the official accounting system, the inclusion of funds committed to contracts (deliverables underway but not costed) more completely reflects program execution and financial status. Commitments were tracked in the DOE accounting system for DNN programs for the first time in FY 2004. When commitments are added to costs, most of the DNN program balances are consistent with sound financial management. The DNN program has submitted a separate report to the authorizing and appropriation committees explaining in detail the program's cost and commitment status. The following programs are the main drivers in the DNN program exceeding the appropriation thresholds.

RTI: ($69 million) Since full funding for an RTI project is required before negotiations begin, it is not unusual that up to 24 months of funding remains uncosted pending project completion. Funds are costed only when project deliverables have been received and approved. At the end of FY 2005, over 120 projects have contracts in place with Russian Institutes. When commitments are added to costs, more than 58 percent was costed or committed, leaving 42 percent uncommitted ($48 million). Funds will be costed as soon as the contract deliverables are completed over the next 24 months. In addition, projects involved in Russia's nuclear cities have been slowed and will be coming to an end temporarily due to the expiration of the inter-governmental agreement.

MPC&A Program: ($358 million) Although the appropriation threshold was exceeded for this program, when commitments are added to costs, 87 percent of the total funds available to cost were costed or committed, leaving 13 percent uncommitted ($93 million), which is consistent with sound financial management. Over half of these uncommitted funds are associated with a supplemental received late in FY 2005 for MPC&A cooperation with countries outside of Russia and the Former Soviet States. The remaining uncommitted funds represent laboratory labor for ongoing contract negotiations and deliverables.

FMD Program: ($249 million) Uncosted balances for this program are due to the liability issue between the U.S. and Russia, which caused a delay in the start of construction of the U.S. and Russian Mixed Oxide (MOX) Fuel Fabrication Facilities. We expect these funds to be costed in FY 2006 and early FY 2007.

EWGPP Program: ($95 million) All of the Seversk project uncosted balances are committed to the project and are required in FY 2006 and FY 2007 to meet the planned FY 2008 completion date. Furthermore, the second fossil fuel power plant being constructed at Zheleznogorsk is expected to obtain approval of Critical Decision 3 (start of construction) in the second quarter of FY 2006 and, therefore, will begin to significantly draw down its uncosted balances in the latter part of FY 2006. The Zheleznogorsk Project uncosted balances are likewise committed to the project and required to complete the purchase of long-lead equipment and to perform the actual construction activities to meet its planned FY 2011 completion date.

Nonproliferation and International Security Program: ($103 million) Uncosted balances for this program are primarily the result of difficulties arising from work in Russia/FSU and delays in negotiating various agreements with Russian institutes and other international partners. Specifics are as follows:

Policy ($71 million): The majority ($47 million) of the uncosted balance is due to unobligated funds held for a major procurement in the Kazakhstan Spent Fuel (BN-350) program. The funds will be used to procure the prototype dual-use cask in FY 2006 and serial production will begin in early FY 2007. Uncosted balances are also in the Russian Fuel Return program due to delays on the part of foreign governments to negotiate contracts/agreements with the United States, which in turn has delayed several shipments of fuel. Several of these negotiations are expected to be completed during FY2006. In addition, $24 million of the uncosted balance is associated with ongoing negotiations for agreements to be signed and then implementation of the agreements to signed contracts. These remaining funds will be committed onto four large contracts in early FY 2006 and costed by late FY 2006 and early FY 2007.

International Safeguards ($18 million): These balances are caused by delays in the signing of the International Atomic Energy Agency Additional Protocol Implementation Legislation in the spring of 2005, delays to the initiation of the Additional Protocol Reporting System that will be fully operational in FY 2006, and the subsequent signing of approximately ten safeguards cooperation agreements with our international partners.

Export Control ($9 million): The uncosted balances will be committed and costed in FY 2006. The program has established a systematic approach to the review of export license applications that must be evaluated on a classified network. Many export control-related trainings and trips were postponed due to scheduling conflicts or to the internal situations of the countries involved. These postponements are outside the program's control. The funding, however, remains obligated for the training, which will be re-scheduled during FY 2006.

Nonproliferation and Verification Research and Development Program: ($72 million) The majority of the work is associated with long-lead procurements for space sensors and lag time in processing multiple year awards for universities. As a result, the uncosted balances will be costed in one to three years. When commitments are considered as well as costs, 90 percent was costed or committed, leaving only 10 percent uncommitted ($32 million), which is consistent with sound financial management.

Appropriation 89X0213, Fossil Energy Research and Development (FERD) - Exceeds the appropriation threshold by a net amount of $95.4 million. The following items are primary drivers for the over-threshold amount: (1) continuing resolutions each fiscal year which have resulted in a delayed procurement cycle (December to December), thereby decreasing the amount costed for selected contracts by as much as 8 percent or one month of costing activity; (2) the execution of competitive contractual instruments such as Broad Based Agency Announcements, Program Research and Development Announcements, Program Solicitations, etc., which require additional time to generate awards and produce higher than normal uncosted balances; (3) contracts of an R&D nature involving long-lead construction deliverables which create delays in the costing; (4) construction deliverable delays in which projects are susceptible to schedule delays due to the inability to obtain construction and/or other related permits; (5) cost-shared Fossil Energy activities that require full funding for a particular budget period or phase of work which may span multiple fiscal years, resulting in work occurring over a longer period of time; and (6) uncosted balances retained to pay final vouchers for contracts in closeout and awaiting final Defense Contract Audit Agency audits. All reported over-threshold balances remain necessary to fund on-going programmatic activities for which they were appropriated.

Appropriation 89X0243, Other Defense Activities – Exceeds the appropriation threshold by net amount of $72.3 million. The primary drivers for this over-threshold amount include: (1) $34 million in interagency agreements issued late in FY 2005 due to the continuing resolution; (2) $10.2 million appropriated for activities that were subsequently transferred to the Department of Labor and in FY 2006 will be used by DOE to continue record retrieval activities; (3) $3.1 million in questionable contractor costs that are being evaluated by the Office of Procurement and Assistance Management -- payments are being withheld until a determination on the questionable costs has been made; (4) the late award of contracts totaling $6.8 million to continue FY 2005 enhancements to the Department's protective force performance testing; and (5) $3.1 million to complete the implementation of vital security initiatives involving Department-wide cyber security and completion of the Performance Test and Analysis Center. Changes in the scope of work resulted in these initiatives not being completed during FY 2005. These balances remain necessary to fund the programmatic activities for which they were appropriated

Appropriation 89X5227, Nuclear Waste Fund – Exceeds the appropriation threshold by a net amount of $100 million. The primary drivers for these over-threshold amounts include: (1) $30 million for subcontracts involving technical support and scientific and engineering studies that were budgeted for in FY 2005 but will not be awarded until early FY 2006; (2) uncompleted work of $40 million due to the continuing resolution related to Repository Design and Site Operations; (3) legacy litigation fees of $10 million; (4) $10 million for cooperative agreements initiated in FY 2005; and (5) the recording of a $10 million lease termination liability in accordance with OMB Circular A-11 (Preparation, Submission and Execution of the Budget) for contractor office space utilized on behalf of DOE. These balances remain necessary to fund the programmatic activities for which they were appropriated.

Appropriation 89X0215, Energy Conservation – Exceeds the appropriation threshold by a net amount of $116.1 million. The FY 2005 ending uncosted balance for the Energy Conservation account was $438.4 million, a reduction of 17.7 percent or $94.3 million from the FY 2005 beginning uncosted balance of $532.7 million. Some programs, such as the Biomass and Biorefinery program reduced their uncosted balance by 64 percent, from a FY 2005 beginning balance of $9 million to an ending balance of $3.2 million.

There are several reasons for the uncosted balances in the Energy Conservation appropriation. One reason is the operating procedures used to allocate the research and development funds. Competitive solicitations are subject to a two month solicitation period, a two month application period and a two to three month period for final award. This delays the obligation of funds significantly. Funds that might otherwise be obligated in December, for example, would be obligated in June or July. Therefore, an additional six to seven months (approximately 48 to 56 percent) of uncosted obligations might be expected at the end of the year.

Another factor that resulted in the uncosted obligations exceeding the threshold was the continuing resolution, which lasted into the second quarter of FY 2005. The delay in receipt of funding, which limited the availability of funds early in the fiscal year and constricted the award of competitive solicitations, resulted in the postponement and delay of procurement activity and the incremental funding of projects/contracts. This delayed the obligations and the subsequent costing.

Also, the Office of Energy Efficiency and Renewable Energy frequently enters into cost-shared research activities, which are subcontracted through the Department's laboratories. The "Building America" program and the Freedom Cooperative Automotive Research Partnership program both are in this category. Funds for these and other cost-shared activities are most often multi-year in nature and require up-front funding to ensure program continuity. This funding process results in higher uncosted balances than normal due to the out year funding commitments.

The Office of Energy Efficiency and Renewable Energy recognizes the opportunity to further enhance management control of uncosted balances and is implementing a new business management system that facilitates structured performance reviews including the review of accrued costs and uncosted balances in relation to technical progress. Also, the office implemented a major reorganization for the purpose of improving program management. The new management processes and organization will increasingly facilitate advanced program planning, the timely transfer of funds to procurement offices for program implementation, and the monthly review of milestone achievements within projected schedules and costs. This emphasis on program and project management, with special attention on carryover balances, could reduce uncosted balances in the future. These funds are necessary to accomplish the programmatic activities for which they were appropriated.

Appropriation 89X0233, Strategic Petroleum Reserve (Petroleum Account) – Exceeds the appropriation threshold by a net amount of $30.8 million. The major driver for this over-threshold amount is the transfer/loan of $43 million from the SPR Facilities Account to finance drawdown operations directed by the President as part of an international effort to bolster oil supplies in the aftermath of Hurricane Katrina. This directive was announced on September 3, 2005, based on the President’s determination and finding that events in connection with Hurricane Katrina resulted in a “severe energy supply interruption” within the terms of the Energy Policy and Conservation Act.

The Department conducted an on-line competitive sale during September 6-9, 2005, and awarded 11 million barrels of crude oil to five companies who submitted favorable bids. Activities financed via the Petroleum Account were power, operations, maintenance and technical support related to the drawdown. Deliveries, which began on September 26, were originally expected to be completed during October. However, the arrival of Hurricane Rita along the Gulf coasts of Louisiana and Texas on September 24, 2005, caused significant damage to several refineries, terminals and distribution systems that reduced the rate at which purchasers could take delivery of crude oil and process it into products. Of the 11 million barrels awarded, 10 million barrels have been delivered to-date. The remaining 975 thousand barrels may not be completed until early 2006. These balances remain necessary to fund the programmatic activities for which they were appropriated.

89X0224, Energy Supply – Exceeds the appropriation threshold by a net amount of $45.6 million. The major drivers for this over-threshold amount are: (1) late issuance of cooperative agreements due to a last minute change in technology, which delayed negotiations and finalization of the work scope for the NuStart and Dominion Nuclear Plant Licensing

Demonstration (COL) projects. Consequently, COL project activities, particularly the reactor vendor activities, did not ramp up until late in the fiscal year. Therefore, the COL projects were unable to execute their planned scope of work resulting in a higher than anticipated carryover at the end of the fiscal year. The agreements total $32 million. (2) $4 million is required to perform the Very High Temperature Reactor Scoping Studies. The funding for these studies was received at the end of FY 2005, but the studies were not intended to be performed until FY 2006. (3) $2 million is required to implement recommendations from the National Transmission Grid Study regarding research and development on cables and conductors, power electronics and substation components. This study was mandated by the President's National Energy Policy. A solicitation for competitive award of these funds under cooperative agreements was completed in August 2005, leaving insufficient time to accomplish any chargeable work under these funds. (4) $3 million is required to complete various activities planned in FY 2005 with expected completion dates in FY 2006 and beyond, involving the Generation IV Reactor Program, Nuclear Energy Research Initiative, Advanced Computational Thermal Fluid Physics Assessments and Advanced Gas Reactor fuel development. (5) $2 million is required to complete 3 projects concerning long-term aging and degradation of light water reactor materials. Funding was received in June 2005; however, the guidance memorandum carefully outlines a September 2006 completion date. These balances remain necessary to fund the programmatic activities for which they were appropriated.

LIST OF ACRONYMS

AIP - Accelerator Improvement Project
CE - Capital Equipment
DNN - Defense Nuclear Nonproliferation
EWGPP - Elimination of Weapons Grade Plutonium Production
FMD - Fissile Materials Disposition
FSU - Former Soviet Union
GAO - Government Accountability Office
GPP - General Plant Projects
MPC&A - Materials Protection Control and Accounting
MOX – Mixed Oxide
NIS - Nonproliferation and International Security
R&D – Research and Development
RTI - Russian Transition Initiative
SFMC – Site/Facility Management Contractor
TAC - Total Available to Cost

<u>APPENDIX</u>